NACS State of the Industry Summit

HALF EMPTY,

HALF FULL

According to data released at the recent NACS State of the Industry Summit, 2015 saw record sales or slow growth—depending on your perspective.

By Jerry Soverinsky

I have a good friend named Bob. Bob's a great guy, but he's a pessimist. He'll never call something "great" or even "good"; rather, everything is phrased in terms of the negative: How was your trip, Bob? "Not as warm as I expected." What was it like catching a foul ball off Jeter? "Not the worst thing I've done." You won the lottery? That's unbelievable! "Not bad, huh?"

You get the idea.

Well, after covering the past eight or nine NACS State of the Industry Summits, I've pretty much decided that the convenience store industry is a lot like my friend, Bob. That is, no matter how well things are going, your assessment is always tinged with the negative.

Picture this: Upon taking the stage for the event's opening session, David Nelson, professor of economics at Western Washington University and president of Study Groups, established the Summit's overarching theme not by showering the crowd with confetti because the industry generated higher profits than it ever has in its entire history, but by showing—wait for it—a short video featuring animated sloths. Sloths.

And why? To illustrate for all, that despite an exceptional, kick-ass year, economic performance has slowed down from its Osain Bolt-like pace of the previous few years. Mind you, there was no dip in profits—recall, it was a record-setting year—rather, the rate of growth had just eased. Somewhat. The glass is half empty. Get it? Bob.

So if you won't say it clearly and up-front, I will: 2015 was a great year for the convenience store industry. The best ever in terms of pre-tax profits: $10.6 billion. And inside sales: $225.8 billion. And foodservice: $32,890 per store per month.

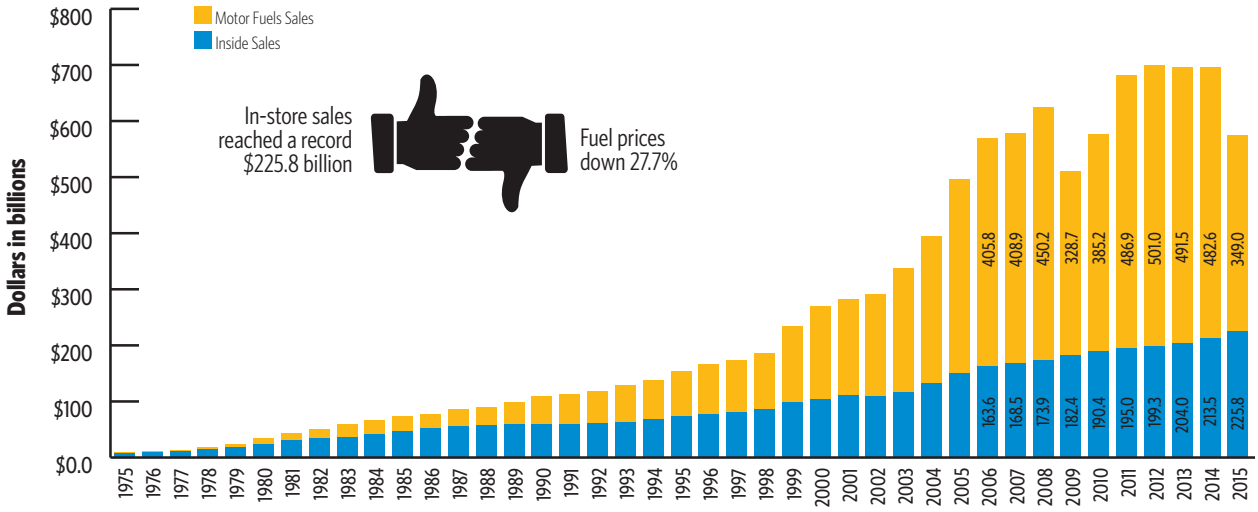
Way. To. Go.

And despite a flurry of perennial "watch outs" that could pose threats to your future success (see drone deliveries and driverless cars, for instance), the truth is that the industry is thriving and well-positioned for success.

"Our industry's prospect for growth is strong," announced NACS Chairman Jack Kofdarali, president of J&T Management, Inc., while welcoming a record 600 attendees to the Summit, a 13% increase over the previous year (also a record). It was an uncharacteristic admission of success, an approach that Kofdarali immediately corrected by noting that tobacco sales in California were low.

And so began this year's Summit.

INDUSTRY SALES



(Source: NACS State of the Industry data)

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Economic Outlook

"We're about seven years into this [economic] recovery ... Is it ready to end? Or will it just die of old age?" Nelson asked rhetorically, hinting at the prospect for another downturn. "It's tough to make predictions, especially about the future," he conceded, a quote he attributed to Yankee great Yogi Berra. "But the economic evidence does not suggest an imminent recession."

Indeed, 84 months into the current recovery, the economy and growth opportunities for convenience stores looks, in Nelson's terms, s-l-o-w—despite the performance numbers that he revealed:

- Wage picture: "We've grown 200,000 jobs per month over the past two years," he said. "Jobs are plentiful ... with job openings climbing faster than the hire rate ... This is great news [in terms of] economic recovery."
- Consumer spending: With employment strong, consumers are also spending more, Nelson said. "In 2015, we had the best yearly performance since 2005 ... with retail spending (except gas) up 4%. Consumer confidence is solid and home sales are up sharply from the recession lows.

Nelson reminded attendees that he projects slower growth in the years ahead, warning of "issues to keep you awake at night": creative tax increase proposals, such as soda taxes and carbon taxes; labor cost issues; and legislative issues, including menu labeling and minimum wage hike proposals.

As for his s-l-o-w characterization, Nelson pointed to prime rates that are trickling up and 10-year treasury rates that are also rising. "The economy is slow, but better to go slowly in the right direction than in the wrong direction."

The Numbers

"Last year was great, but this year was great, too," said Billy Milam, president of RaceTrac Petroleum Inc. and a member of the NACS Research Committee, in kicking off the industry's most anticipated annual presentation—"The Numbers." "Bubba is almost back," Milam declared, a reference to the industry's generic c-store customer moniker.

Key performance metrics for 2015 included a 5.8% jump in inside sales, a 1.6% rise in pre-tax profits and a sizable 12.8% drop in credit card fees, "not because of Durbin," Milam said. "The real reason is our fuel margins."

So generous have been the margins—22.3 cents per gallon in 2014, 21.0 cents per gallon in 2015—that "a lot of people ... got fat without doing the work," Milam said. "Out of 155,000 convenience stores in the country, there are some that shouldn't be in business any longer. They're in business because of fuel margins." He then asked attendees rhetorically: "You've been blessed with great fuel margins— what have you done with that? Are you prepared for what might happen?"

Dollar stores remain a lasting competitive threat, Milam said, "They're a little bit of a sleeping giant." And while their recent foray into tobacco sales have not yet grabbed significant market share, "they've only been doing it for three years." Rest assured, he

Fuel prices dropped and fuel margins expanded, putting more $ in consumer pockets

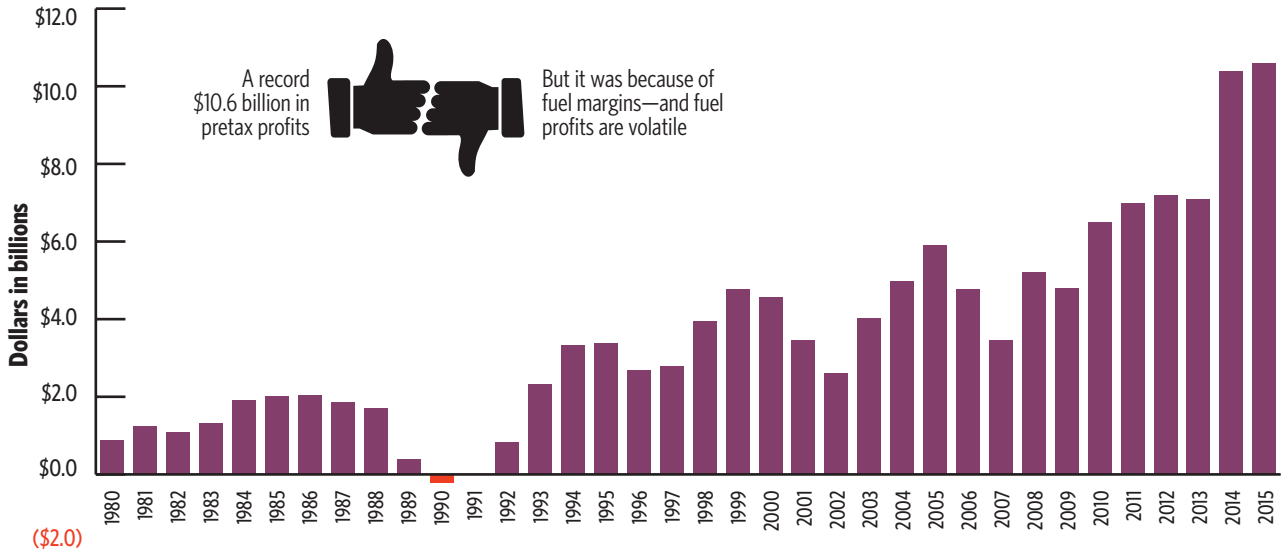
Even though profit was up, overall sales were down—and are current fuel margins sustainable?

2015 SALES, SAME FIRMS

Sales (store/month)	2014	2015	Change
Total All Sales	$606,783	$491,003	(19.1)%
Fuel Sales	$488,606	$353,347	(27.7)%
Fuel Gallons	146,519	147,508	0.7%
Average Selling Price	$3.33	$2.40	(28.2)%
In-Store	$147,902	$156,411	5.8%
Foodservice	$30,012	$32,890	9.6%
Merchandise	$118,301	$124,001	4.8%
Mdse Less Cigarettes	$70,614	$75,678	7.2%
Cigarettes	$48,700	$50,357	3.4%

(Source: NACS State of the Indsutry data)

2015 INDUSTRY PRETAX PROFITS



(Source: NACS State of the Industry data)

said: "These guys are a force to be reckoned with ... and a continued threat to our industry."

Next, he turned to less recognizable external threats, which he urged retailers to monitor. There are mobile gas services ("While they might not be able to do it with scale ... at some point, somebody will figure out how to do it."); take two of online grocery ("The target demographic is a generation that grew up with an iPhone in their hands."); and a slew of on-demand services (Uber, et al) that rely on 1099 employees, meaning "they're not on the hook for benefits."

Despite these and other challenges, Milam remained bullish that the convenience store industry could withstand such challenges, highlighting its key competitive advantages: "We're convenient ... on the best corners in the country."

As to whether 2016 will generate the same robust returns as last year and 2014, Milam asked: "We've had two of the best years we've ever had. What are the odds for a third [great] year? Is it time for there to be a thinning of the herd? A reckoning day?"

But with direct store operating expenses growing at a faster rate than inside gross profit dollars for every month in 2015 and a more competitive labor pool, he alluded to his own prediction. "We've become a little fat and happy."

Andy Jones, president and CEO of Sprint Food Stores, Augusta, Georgia, concurred when he took over the second half of "The Numbers" presentation. "Cheap gas was definitely good for everyone in this room," he said. Jones continued by shedding some light on key drivers of the fastest growing in-store categories and assessed changing merchandise and foodservice trends.

The top 10 in-store categories ranked by sales dollars represent about 80% of all in-store sales. "The top quartile does about two times the business of the bottom quartile in most core merchandise categories." Jones said. "But food and dispensed beverage is where the top quartile has a vast difference over the bottom quartile. The gap between the top and bottom quartile is over five times in hot dispensed beverage and almost four times that in prepared food." Jones summed up the top quartile's secret to success succinctly: "The top quartile companies in this room are killing it in foodservice."

Labor Pains

Labor organizing is undergoing rapid change, began Joe Kefauver, managing partner of Align Public Strategies, as he laid out the challenges ahead for retailers. "Labor organizing used to take place within the four walls of a business ... but not today," he said. "And the venue is different, too. It used to take place in Washington, D.C. or state capitals, but it's playing out in city halls across the country today."

Election times are also reduced, "down from 90 days to in some cases just 14," with many allowing elections to take place online.

Some companies are implementing voluntary minimum wage increases, and "while this might be the right ethical thing to do, don't think that changes the organizing narrative and calls off the dogs," Kefauver said, as the return on investment to organize becomes more profitable as wages increase.

For business owners, relief will not come at the ballot box this election cycle—at least not in the short term. "A change in party leadership in Washington will not change the movement," he said. "It will be at least two or three years with the current board makeup of the NLRB (National Labor Relations Board) for any changes to be [felt]."

To mitigate the effects, Kefauver urged compliance with evolving regulations ("our Achilles heel"), a critical endeavor "because there's an industry of regulators and lawyers waiting for us to trip up so that they can file unfair labor practice complaints."

The industry should be working together to drive a national conversation on compliance to overcome vulnerabilities, while simultaneously focusing attention at the local level. "In most cases, the local chamber of commerce is not a lobbying arm ... That leaves an opportunity for the convenience store industry to step in that void"—a necessary step to help shape labor issues moving forward.

"It's a very different game right now, and how you prepare as business owners and what you do over the next few years is important as to whether your business model survives," Kefauver concluded. "If you don't do it right, in two or three years, it will be unrecognizable."

Shopper Trends

"There are more growth opportunities than you may be aware of," began Todd Hale, former senior vice president of consumer and shopper insights and consultant for The Nielsen Company, who told Summit attendees that the $821 billion retail universe "is growing slowly at roughly 2%," the result of slowing population growth, stagnant wages and a staggering 21% of those 18 years and younger falling below the poverty level.

Dollar store growth continues to climb "and is the highest in the U.S.," Hale said, adding that he expects the trend to continue as the channel moves to the West Coast. "They're competing by selling name brands now."

Looking forward, Hale sees the following in store for 2020 and beyond:

- E-commerce will continue to be the big winner, growing at roughly 12% per year for the next five years.
- Just behind e-commerce will be the convenience store channel, which he expects to realize slow but steady growth. "Six of the 10 fastest growing retail categories are in the top 10 selling list of convenience stores," he said.
- Tobacco, beer and New Age beverages will be category winners for convenience stores, as they

2015 GROSS PROFIT $, SAME FIRMS

Pool margins stayed at high levels in 2015

Cigarette profit increased, thanks to the $2 billion "gift" from CVS, but category margins are still low and compressed

Per Store/Per Month	2014	2015	Change
Total Gross Profit	$82,992	$85,429	2.9%
Fuel	$33,001	$31,925	(3.3)%
Pool Margin cpg	22.52	21.64	(3.9)%
Margin – CC Fees	17.15	16.95	(1.1)%
In-Store	$47,853	$50,777	6.1%
Foodservice	$16,381	$17,349	5.9%
Merchandise	$31,696	$33,682	6.3%
Mdse Less Cigarettes	$25,303	$27,435	8.4%
Cigarettes	$6,706	$6,740	0.5%

(Source: NACS State of the Industry data)

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control more than 50% of the market share for each.
- Supermarkets will realize long-term growth, because their in-store experience with a focus on food is strong. "This should cause you to lose sleep," he warned.

Moving forward, Hale urged a greater attention to connecting with shoppers, noting that 39% of convenience store sales come from households with income less than $29,000. "Spending power is important; we have to learn how to drive their behavior."

Demographic Trends

"You guys have survived and thrived ... reinventing yourselves for relevance," began John Martin, CEO of GenerationsMatter, before warning of "major shifts ahead" for convenience retailers, which will offer both challenges as well as opportunities:

- The population will grow from 323 million to 358 million by 2030, with an increase in urban living and a diversity shift where those 18 and under will become the minority; and the U.S. Hispanic population will double by 2050. "This presents a huge niche opportunity," he said.
- The population is also aging, with an increasing life expectancy and a decreasing birthrate. "We'll have just as many people 65 and older as 18 and under by 2030," Martin said. "While there are 38 million seniors today, there will be 72 million by 2030."
- Roughly 50% of the workforce will telecommute by 2020, which "will result in fewer shopping trips, spontaneous and other," he said. "This will mean a reduction in c-store drive-by times."

To capitalize on these and other trends requires a "new lens on the future," one that embraces the millennial's idea of living and sharing their experiences. "They believe everyone is special and no one is best ... It's a we, we, we generation." As a result, employers can enhance opportunities to engage millennials by "being all about purpose. They will trust that company more."

Martin urged continual refinement to achieve relevance, whether that's preparing for older customers by adding better lighting, appealing to Gen Xers with their preference for easy-to-make meals, or engaging millennials with healthier foods and a corporate mission that's purposeful.

"You're selling milk, bread and eggs," Martin concluded. "But you can do more. The heart of the community. That's who you are."

Design Thinking

"Design is a way of looking at the world ... putting people first," said David Schonthal, clinical assistant professor of innovation and entrepreneurship at the Kellogg School of Management at Northwestern University and a leader in the Business Design practice at IDEO, a company that identifies and designs new opportunities to connect with consumers.

After a well-received icebreaker whereby attendees were instructed to sketch a portrait of their neighbor, Schonthal explained that the exercise was designed to encourage trying something new while looking at the world slightly differently.

"None of this is technical," Schonthal said, displaying an intricate portrait sketched by a computer in a matter of seconds, "but it does require an open mindset to see the world a little differently."

Innovation is the result of that kind of thinking—"design thinking"—a systematic approach that involves three steps:

1. **Learn about the world:** Get out into the world and meet, face-to-face, the people whose problems you want to solve. "Observe human behavior. This is the first step in designing a compelling offer," he said. But don't merely rely on mainstream users.

AND STILL MORE...

Other speakers offered additional insights at the Summit, both on the main stage as well as during breakout sessions.

Kevin Book, co-founder and managing director of ClearView Energy Partners LLC, addressed energy volatility in a changing world, summing up three energy realities in just eight words:

- Significant government control
- Limited data quality
- Infrastructure life

"Gas consumption is sticky, you're not going to not drive to work," he said, trying to reassure attendees that the need for fuel is not going away anytime soon.

And while this year's political candidates hold disparate views of energy policy, Book said the net result will be that little will change—at least in the short term. "While politics can change quickly, energy doesn't ... We have hydro plants that are 95 years old. A politician can make a decision that takes 10 years to take effect," he said. "Change here is very slow."

Performance for individual regions (South Central, West, Northeast, Midwest, Southeast and Central Regional) was dissected in afternoon breakout sessions, allowing attendees to gather more in-depth geographic information relevant to their operations. These sessions were moderated by the NACS research team—Dae Kim, Leroy Kelsey and Bob Swanson—with contributing insights offered by key industry retailers and suppliers.

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Card fees down 11.5%

Wages and benefits up 7.3%

Per Store/Per Month	2014	2015	Change
Wages & Benefits	$24,508	$26,297	7.3%
Card Fees	$7,449	$6,595	(11.5)%
Utilities	$3,331	$3,370	1.2%
Repairs & Maintenance	$3,245	$3,468	6.9%
Supplies	$1,580	$1,648	4.3%
Total DSOE	$47,375	$48,786	3.0%
Facility Expense	$10,917	$11,743	7.6%
Total DSOE & Facility Expense	$58,292	$60,528	3.8%

(Source: NACS State of the Industry data)

The best ideas "come from the edges"—those people who may be novices or advanced users—from which a solution can be developed.

2. **Have some ideas:** "To have a good idea, first have a lot of ideas," Schonthal said, quoting scientist and educator Linus Pauling. While the process unfolds, it's essential to defer judgment, as good ideas often come from ones that at first glance are less than inspiring.
3. **Make the ideas real:** "You've all got the tools to bring the future to life," he said, whether that's prototyping a new store layout with foam core to gauge customer reaction or testing a value proposition digitally via Google Adwords.

"Design thinking takes just a ... little creative confidence of looking at the world differently," Schonthal concluded.

Future of Fuels

"I question whether the Tesla 3 will be a game changer for our industry," began John Eichberger, executive director of the Fuels Institute, while addressing the electric car's explosive opening day sales (180,000 units). "It's still a very small percentage of the vehicle pool in the United States."

However, options are increasing for consumers with more than a dozen electric vehicles (EV) now available in the United States. "As customers see them parked at work and school, that will increase their marketability," he said. "And when there are 20 or 25 different vehicles on the market, it could convince people to test drive them."

Eichberger said that EV technology is improving, with range, recharge time and price all becoming more favorable for consumers. Attendees weren't buying the hype, though: An interactive poll revealed that a plurality (40%) believed that EV sales would capture no more than 10% of U.S. car sales by 2025.

Turning to hydrogen, Eichberger said the fuel option solves many of EV limitations: Refueling is done in just three to five minutes and you can travel more than 300 miles on a fill-up. "But there are only 15 stations right now [that offer hydrogen refueling]," he said. "And at $2 million per station, is it running behind the times?" he asked rhetorically.

He warned that the future's driving pool may shrink, with ride sharing and—who knows?—driverless cars taking over our roads. Additionally, millennials are locating in urban environments, where car ownership is more expensive and public transportation is dominant. "Car sharing is a real threat," he said. "However, we're not seeing a change in gas consumption [because of it]. Yet."

Citing a poll taken of college students who were asked to redesign transportation, "not one mentioned convenience or fuel retailing. All mentioned autonomous or EVs or commuter rail. They don't see a role for our industry," Eichberger said.

Network Connections

Attendee interest was enthusiastic and sustained throughout the SOI, with early all presentations and breakout sessions generously attended. Networking receptions brought together attendees for quality relationship building. And the majority celebrated a job well done, albeit distributing well-deserved accolades sparingly.

It was the NACS State of the Industry Summit, after all. NACS

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